IN THE

Supreme Court of the United States

TION FOR A WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF
APPEALS FOR THE NINTH CIRCUIT

SUBJECT INDEX

	PAGE
Opinions below	1
Jurisdiction	2
Question presented	2
Statutes involved	3
Statement	3
Reasons for granting the writ	10
Conclusion	32

Appendices:

Appendix A. Opinion of the United States Court of Appeals for the Ninth Circuit ..... App. p. 1

Appendix B. Judgment ..... App. p. 4

TABLE OF AUTHORITIES CITED

CASES

A. & A. Tool & Supply Co. v. Commissioner, 182 F. 2d 300 ..... 10, 18, 24

Bradstreet Co. of Maine v. Commissioner, 65 F. 2d 943 ..... 10, 11, 18, 24

Cohan v. Commissioner, 39 F. 2d 540 31

Engle v. State of Arizona, 53 Ariz. 458 13

J. M. Perry & Co. v. Commissioner, 120 F. 2d 123 29

Rainwater, H. T. 23 T. C. 450 ..... 24, 27

Ross v. Commissioner, 15 T. C. M. 23, Dec. 21,511(M), (T. C. Memo. 1956-5) 26, 27

Schira v. Commissioner, 240 F. 2d 672 ..... 10, 11, 18, 24

Showell v. Commissioner, 238 F. 2d 148 ..... 6, 20, 30

Showell v. Commissioner, 16 T. C. M. 103, Dec. 22,239(M) (T. C. Memo. 1957-22) 2, 30, 31

Snyder v. Commissioner, 14 T. C. M. 1126, Dec. 21,310(M), (T. C. Memo. 1955-293) 27

Thomas v. Commissioner, 232 F. 2d 520 28

DICTIONARY

Thorndike-Barnhart Dictionary (1951 Ed.) 26

MISCELLANEOUS

2 Commerce Clearing House Federal Tax Reporter (1953), par. 386.011 24

19 Tax Court Memoranda, p. 30, Dec. 24,027(M), (T. C. Memo. 1960-7) 2

RULES

Rules of the Tax Court, Rule 32 ..... 22, 23

STATUTES

PAGE

Internal Revenue Code of 1939, Sec. 23(h) 14

Internal Revenue Code of 1939, Sec. 41 .....
..... 2, 3, 10, 11, 17, 20, 22
23, 25, 26, 29, 30, 31

Internal Revenue Code of 1954, Sec. 446 11

United States Code, Title 28, Sec. 1254 2

TEXTBOOKS

2 Mertens, Law of Federal Income Taxation, Sec. 12.12 ..11, 24

9 Mertens, Law of Federal Income Taxation (1943), Sec. 50.71 29

IN THE

Supreme Court of the United States

OCTOBER TERM, 1960

No. .....

JACK SHOWELL and DOROTHY SHOWELL,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

The Petitioners pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Ninth Circuit in the above entitled case.

Opinions Below.

There have been three opinions of the Tax Court of the United States in this case, and there have also been three opinions of the Court of Appeals.

The first of the Tax Court opinions, a regular opinion [R. 14760 at 11-27], was promulgated December 16, 1954, and the findings of fact and opinion are reported at 23 T. C. 495. The second Tax Court opinion [R. 15710 at 22-27], a memorandum opinion, written after a remand by the Court of Appeals, was

promulgated January 31, 1957, and the findings of fact and opinion, although not officially published, may be found at 6 T. C. M. 103, Dec. 22,239(M), T. C. Memo. 1957-22. The third Tax Court opinion, also a memorandum opinion [R. 16872 at 84-90], written after a second remand by the Court of Appeals, was promulgated January 29, 1960, and the findings of fact and opinion of the Tax Court, which are also not officially published, may be found at 19 T. C. M. 30, Dec. 24,027 (M), T. C. Memo, 1960-7.

The first opinion of the Court of Appeals is reported at 238 F. 2d 148 and is unofficially reported at 56-2 USTC ¶9964. It was rendered on October 10, 1956. The second opinion of the Court of Appeals is reported at 254 F. 2d 461 and is unofficially reported at 58-1 USTC ¶9455. It was handed down on April 14, 1958. The third opinion of the Court of Appeals is reported at 286 F. 2d 245 and is unofficially reported at 61-1 USTC ¶9218. [R. 16872 at 105; App. A, *infra.*]

Jurisdiction.

The judgment of the Court of Appeals was entered on January 9, 1961. [R. 16872 at 107; App. B, *infra.*] The jurisdiction of this Court is invoked under 28 U. S. C., Section 1254.

Question Presented.

Whether, once the Commissioner has rejected a taxpayer's books and records under the authority of Section 41 of the 1939 Internal Revenue Code, he must then adopt some *method* of reconstructing income.

Statutes Involved.

Section 41, Internal Revenue Code of 1939 provides:

> The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year as defined in section 48 or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year.

Statement.

Instead of asserting deficiencies on the basis of either the bank deposits or net worth and disbursements method of determining income, the Commissioner determined the instant deficiencies by relying wholly on the correctness and veracity of one of petitioner Jack Showell's permanent records in evidence as Exhibit 3. This exhibit was the sole basis, aside from the usual legal presumption of *prima facie* correctness attaching to the Commissioner's determination, of the two deficiency notices. This fact was admitted by the examining agent, U. S. Internal Revenue Agent H. L. Mende, who testified on direct examination as follows:

"Q. Mr. Mende, is the Exhibit 3, which is now in evidence, the only source of the amount of $11,281.83 set forth in the notices of deficiency?

A. To the best of my knowledge and belief, it is." [R. 14760 at 45.]

In short, all of the entries appearing in the "Gain" column of Exhibit 3 were adopted by the Commissioner while all, except for a few entries representing certain expense items, entries appearing in the "Loss" column of Exhibit 3 were rejected: [R. 14760 at 16-18, 51.] Such action was taken by the Commissioner in spite of the fact that the entries made in both the "Gain" and "Loss" columns were net gains or net losses. [R. 14760 at 15.] That is, the total of all losing bets was deducted from the total of all winning bets and the resulting net gain or net loss entered on Exhibit 3 under the "Gain" column if a net gain or the "Loss" column if a net loss. [R. 14760 at 14, 15.] In explaining the procedure used to determine petitioners' "correct" income, Agent Mende testified:

"Q. Were any of the gains or losses used in computing the 'Gain' column substantiated?

A. No more than the losses.

Q. In other words, is it correct to say that you accepted all of the amounts in the 'Gain' column and rejected all the amounts in the 'Loss' column?

A. Except those expenses I told you about." [R. 14760 at 51.]

From the above material it is quite clear that the Commissioner accepted both the method of accounting regularly employed by petitioners [R. 14760 at 104]

and the truthfulness and accuracy of his permanent record [Ex. 3] for the purpose of computing and asserting deficiencies in income tax. However, it is equally clear that the Commissioner rejected the same method of accounting, and the accuracy and truthfulness of the same permanent record [Ex. 3] when any entries resulted in a conclusion that no additional income had been realized.

At the trial no testimony or evidence of any kind was introduced by the Commissioner with the exception of the 1949 federal income tax return of each petitioner. Indeed, the Commissioner's counsel frankly stated at the opening of the hearing why none could be expected:

> ". . . You may wonder why we are here in such a case, but this is somewhat of a test case to see how far a person engaged in the betting and booking business may operate without keeping the usual records which are kept by a merchant and a man in business . . ." [R. 14760 at 39.]

In other words, the adequacy of petitioner Jack Showell's records was presented as the issue. Yet at the same time the Commissioner himself relied solely on the authenticity, accuracy and veracity of certain of the entries (those appearing under the "Gain" column) of Exhibit 3.

The Tax Court, after excluding petitioner Jack Showell's testimony as to his personal disbursements for the year 1949, sustained, in its first regular opinion of December 16, 1954, most of the deficiency determined against each petitioner by the Commissioner in his no-

tice of deficiency to each. It did, however, decrease the asserted additional income in the sum of $3,000. Thus, the $11,281.83 of additional income asserted in each deficiency notice (½ of $22,563.66) was reduced by one-half of $3,000 or $1,500. In effect, the Tax Court held that the entries in the "Loss" column of Exhibit 3 were reliable to the extent of $3,000 more than the $345.22 ($59.40—Western Union, $125.00—Rent, $60—Associated Press, $100.82—Telephone) previously accepted by the Commissioner. The Tax Court did not state which of the entries in the "Loss" column were reliable and which were not, or why the "Loss" column entries were reliable only to the extent of $3,000. The consequence of this decision was to disregard a total of $20,144.77 in record entries appearing under the "Loss" column of Exhibit 3 [R. 14760 at 17, 18], and thereby find that petitioners realized additional income of $19,536.66 in 1949.

Later the cases went to the Ninth Circuit for the first time, and it was then decided by the majority, U. S. Circuit Judge Pope dissenting and urging reversal, that "the only thing that justifies the conclusions reached by the Commissioner or the Tax Court is disbelief or dissatisfaction with the testimony," but the "findings are not sharp enough to tell us this." Consequently, the cases were remanded to the Tax Court on the ground that "the findings are not sufficiently definitive." (*Showell v. Commissioner*, 9 Cir., 1956, 238 F. 2d 148, 153.)

Thereupon, without hearing further evidence, the Tax Court again reached the same decision which it

reached the first time in its regular opinion of December 16, 1954. 23 T. C. 495. However, in its second opinion, a memorandum opinion, 16 T. C. M. 103, Dec. 22,239(M), T. C. Memo. 1957-22, [R. 15710 at 22-27] the Tax Court, reduced its findings of facts from 1496 words to 123 words, and added one new and important finding. It found that petitioner Jack Showell did not keep regular, adequate and permanent books and records of his wagering transactions. [R. 15710 at 23.]

After a second appeal to the Court of Appeals, a second majority opinion filed April 14, 1958, again remanded the case to the Tax Court for further evidence respecting the authenticity of Exhibit 3 and directed the Tax Court to set aside its findings and decision. At the Tax Court hearing held on October 14, 1959, the Commissioner of Internal Revenue introduced the testimony of a document expert to the effect that the entries found in Exhibit 3 were not made on the dates appearing opposite the entries. [R. 16872 at 79-81.] That is, the Commissioner placed a witness on the stand for the purpose of destroying the authenticity and veracity of Exhibit 3 which his agent, U. S. Internal Revenue Agent H. L. Mende, testified was the *sole basis* of the Commissioner's determination of a deficiency against each of the petitioners.

Thereafter, on January 29, 1960, the Tax Court rendered its third opinion in this case, a memorandum

opinion, in which it reached the same conclusion it had reached in the first two opinions. Again it found as fact the identical 123 words which served as its findings of fact in its earlier second opinion saying that:

> "Since we adhere to the same conclusion formerly reached we consider it unnecessary to set aside our previous findings of fact and decision." [R. 16872 at 85.]

With respect to Exhibit 3 and the testimony of the Commissioner's document expert, the Tax Court held that:

> "Upon further consideration of the additional evidence introduced, we find no good reason to depart from the findings of fact and decision previously entered. The evidence tends to support our previous distrust of the authenticity of Exhibit 3 as a contemporary record." [R. 16872 at 89.]

In short, the Tax Court held in its last opinion not only that petitioner's books and records were inadequate but that Exhibit 3 is not an authentic contemporary record. Yet it is this same Exhibit 3 which U. S. Internal Revenue Agent H. L. Mende testified was the *sole basis* of the alleged additional income set forth in the notices of deficiency issued by the Commissioner to each of the petitioners. Also, it is this same Exhibit 3 from which the Tax Court found that the asserted additional income should be reduced by the sum of $3,000.

Subsequently, when the Court of Appeals reviewed, for the third time, the Tax Court's action, it sustained the Tax Court on the ground that:

> "Since the burden of proof was not met, the decision must be affirmed." [R. 16872 at 106; 286 F. 2d 245, 246.]

The reason the Court of Appeals assigned as the basis of such a conclusion was that "when no *new* evidence was offered by petitioners and the court in effect rejected Exhibit 3 as without probative value, there was no evidence upon which the Tax Court could redetermine anything." [R. 16872 at 106.] To paraphrase the Court of Appeals, the reasoning runs thusly:

1. Exhibit 3 was the sole basis of the Commissioner's determination of a deficiency against each petitioner.

2. The Tax Court rejected Exhibit 3 as being without probative value.

3. Therefore, the taxpayer must lose because he has not carried his burden of proof by offering new evidence to overcome that determination which was based solely upon an exhibit which was without probative value.

Or, to put it another way, the Court of Appeals has ruled that a taxpayer's burden of proof requires him to overcome the Commissioner's determination of a deficiency even though the sole basis of that determination has been abandoned by the Commissioner and the Tax Court.

Reasons for Granting the Writ.

1. There now exists a conflict among the Courts of Appeal on the issue of whether Section 41, Internal Revenue Code of 1939, requires that once the Commissioner has rejected a taxpayer's books and records, he must then adopt some method of reconstructing income. In *Bradstreet Co. of Maine v. Commissioner*, 1 Cir., 1933, 65 F. 2d 943,[1] and *Schira v. Commissioner*, 6 Cir. 1957, 240 F. 2d 672, it was held not only that the Commissioner must adopt a method of determining income when he rejects a taxpayer's books and records, but that such method must be reasonable. Similarly in *A. & A. Tool & Supply Co. v. Commissioner*, 10 Cir., 1950, 182 F. 2d 300, 302, the court required both a method and that such method must properly reflect the taxpayer's income.

On the other hand, the Court of Appeals in this case has ruled that there is no such requirement that the Commissioner must adopt some method of determining income once he has rejected the taxpayer's records. The rule of law requiring the adoption of a method of determining income was assigned as error and argued to the Court of Appeals in both the second and third appeals herein, but was clearly rejected by the Court of Appeals when it held that the burden of proof was on the petitioners to present new evidence after the Commissioner and Tax Court had ruled that their records [Ex. 3] were inadequate.

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[1]In *Bradstreet, supra*, the First Circuit also held that "the burden to adopt a method that will clearly reflect the income is on the Commissioner equally as well as on the taxpayer."

2. The conflict which exists as a result of the failure of the Court of Appeals to require that the Commissioner must adopt a method of reconstructing income once he has rejected a taxpayer's records adversely affects all pending tax litigation (except in the First, Sixth and Tenth Circuits) wherein the Commissioner has rejected as inadequate the taxpayer's books and records.

3. Section 41, Internal Revenue Code of 1939,[2] requires that when the Commissioner rejects a taxpayer's records, he must then adopt a *method* of determining income which clearly reflects income. *Bradstreet Co. of Maine v. Commissioner*, 1 Cir. 1933, 65 F. 2d 943; *Schira v. Commissioner*, 6 Cir. 1957, 240 F. 2d 672; 2 Mertens, Law of Federal Income Taxation, §12.12. Furthermore, "'the burden to adopt a method that will clearly reflect the income is on the Commissioner equally as well as on the taxpayer." *Bradstreet, supra.* Here, the Commissioner has not even adopted a method of determining income much less a method which clearly reflects income. Consequently, the requirements of Section 41 have not been met by the Commissioner or enforced by the Tax Court and the Court of Appeals.

4. The decision of the Ninth Circuit has serious implications for all taxpayers particularly in cases involving criminal prosecution for income tax evasion. As the Court knows there are two questions in every income tax evasion trial. They are: (1) Was there additional income upon which tax was due and owing.

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[2]The 1954 successor to Section 41, Internal Revenue Code of 1939 is Section 446, Internal Revenue Code of 1954.

and (2) Did the taxpayer willfully intend to evade that tax? Since very few taxpayers ever testify that they did intend to willfully evade tax, the answer to the second question is, therefore, obtained by a jury from all of the circumstances including the amount of the tax unpaid. Thus, the question arises as to whether this Court would approve, in a case involving criminal prosecution for income tax evasion, the Commissioner's determination of additional income under the facts similar to this case. If not, why not? The issue of whether there was additional income or not is the same whether the matter is a civil deficiency or a criminal prosecution.

Thus, the issue is posed. May the Commissioner disregard a taxpayer's books and records, assert a deficiency based upon no method of determining income but only upon a portion of those same disregarded records, and then be sustained by the Court of Appeals on the ground that since the records relied upon by the Commissioner were not authentic the taxpayer loses because he has not carried his burden of proof.

In order to understand the issue in this case it is necessary to know a little more detail respecting the background of this petition and how the issue arose.

To begin with, this case involves a petitioner, Jack Showell, who, during 1949, was engaged, on a part time basis, in the business of booking bets on football, baseball, and basketball games. [R. 14760 at 12.] To be blunt, he was a bookmaker participating in an activity which is frowned upon in the State of Arizona and made illegal in some other States. However, in Arizona, such bookmaking does not violate the criminal

gaming statutes. *Engle v. State of Arizona,* 53 Ariz. 458 (1939). Furthermore, petitioner Jack Showell was aware that the law of Arizona did not prohibit bookmaking because he was a party to the above cited case.

During 1949 petitioner Showell, according to the Tax Court's first findings of fact, 23 T. C. 495, [R. 14768 at 12-16] accepted bets on either of two teams participating in a baseball, basketball, or football game. When a bet was accepted, 90% of which bets were received over the telephone, no receipt or ticket or slip was delivered to the bettor. Instead, a notation of the bet was made by petitioner Showell on an individual slip of paper or on a tally sheet. After the game had been played the slips of paper and tally sheets were examined and each winning bet was marked with a circle whereas each losing bet was marked with an "x". At the end of the day, if a baseball or basketball game was involved, or at the end of a week in the case of a football game, the petitioner read off to Houston L. Walsh, who shared an office with him the amounts entered on the slips of paper and the tally sheets which were to be paid to winning bettors, and Walsh then totaled them on an adding machine. A like procedure was used for determining the amount of the losing bets. When the totals were thus obtained, a similar procedure was followed with Walsh reading to petitioner Jack Showell from the slips of paper and tally sheet and petitioner operating the adding machine. After the foregoing procedure had been completed, entries were then made on Exhibit 3. If the total of the amounts of the bets made by losing bettors exceeded the total of the amounts to be paid to winning bettors,

the amount of the excess was entered on Exhibit 3 under a column entitled "Gain". Conversely, if the total of amounts to be paid winning bettors exceeded the total of the amounts of bets made by losing bettors, the excess was entered on Exhibit 3 in a column under the heading entitled "Loss." The entries made on Exhibit 3 from January 1 to December 7, 1949, were made by Walsh while the remaining entries were made by petitioner Jack Showell.

After all of the claims of bettors had been cleared petitioner kept Exhibit 3 as a permanent record of his bookmaking business for the year 1949, and discarded the individual slips and tally sheets.

In 1950 petitioners each filed a separate federal income tax return showing a net income of $8,832.66 or a joint total of $17,665.32. Since Exhibit 3, the permanent record of the bookmaking business for the year 1949, reflected that a loss of $581.09 had been sustained, neither income nor loss was reported therefrom.[3] Nevertheless, petitioner maintained and kept in his possession Exhibit 3 as a permanent record even though he ultimately terminated his business of booking bets at the end of 1951. [R. 14760 at 57.]

Subsequently, in 1952, at the height of certain election year reorganizations, the U. S. Internal Revenue Service (the then U. S. Bureau of Internal Revenue) formed a "Rackets Squad" to examine specially the returns of individuals engaged in certain types of activities included among which was the business of book-

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[3]Losses are deductible only to the extent of winnings. Section 23(h), Internal Revenue Code of 1939.

ing bets. There followed an audit of the 1949 federal income returns of petitioners by U. S. Internal Revenue Agent H. L. Mende. During the course of this audit, Mr. Mende was given Exhibit 3 which showed the total of $22,908.88 for the entries appearing under the column entitled "Gain" and the total of $23,489.97 for the entries appearing under the column entitled "Loss". After asking for the names, addresses and amount of every bet that was "paid out" during 1949 and being told that it would be impossible to furnish same [R. 14760 at 89], Mr. Mende thereupon asserted that petitioners realized additional income from booking bets in the total sum of $22,563.66. This sum was derived from the $22,908.88 total appearing under the "Gain" column of Exhibit 3 less the four items totaling $345.22 (Rent—$125.00, Western Union—$59.40, Associated Press—$60.00, Telephone—$100.82) leaving the said $22,563.66. That is, Mr. Mende, the Commissioner's agent, accepted one-half of Exhibit 3 as being accurate, but rejected the other half, with the exception of the above-referred-to four items.

At the subsequent first hearing in the Tax Court, when explaining the source and basis of the amounts of additional income asserted in the notice of deficiency sent to each petitioner, Mr. Mende testified that Exhibit 3 was the *only* source of the amount of $11,281.83 (½ of $22,563.66) set forth in each notice of deficiency. [R. 14760 at 45, 48-52.] In explaining why the entries appearing under the column entitled "Loss" were rejected, the Commissioner's agent testified as follows:

> "Q. Mr. Mende, would you explain to the Court why the figures appearing in the 'Loss' column

on Exhibit 3 were disallowed or rejected as proper losses from gambling operations? A. They were not substantiated *as to who they were paid to* and, of course, gambling losses were not to be allowed in excess of the gains. We were not able to determine how much money was earned by commissions and how much was lost by wagering, and *they wanted to test it out whether proper records should be kept in the case.*

Q. Were any of the gains or losses used in computing the 'Gain' column substantiated?

A. No more than the losses.

Q. In other words, is it correct to say that you accepted all of the amounts in the 'Gain' column and rejected all the amounts in the 'Loss' column? A. Except those expenses I told you about." [R. 14760 at 51.]

That is, the Commissioner asserted the deficiencies based on only one-half of Exhibit 3 because he could not ascertain to whom money had been paid and because he wanted to set up a test case to see what records must be kept by a taxpayer in this type of business having concluded on the one hand that petitioner's record [Ex. 3] was inadequate while on the other hand relying upon it as the sole basis of the deficiencies.

That the deficiencies were asserted by the Commissioner after first concluding that Exhibit 3 was an inadequate record and in a pique because the Racket Squad investigation of the returns of others who received money from petitioner Jack Showell was, in his opinion, thereby hindered is further shown by the very

frank opening statement of the Commissioner's counsel at the hearing:

> ". . . You may wonder why we are here in such a case, but *this is* somewhat of *a test case to see how far a person engaged in the betting business may operate without keeping the usual records* which are kept by a merchant and a man in business, so that the Commissioner is able to go through the records and ascertain whether in fact, a taxpayer did operate the way he says he did; whether he had the losses he said he did; and whether the Commissioner could check, like in an ordinary business, where money is paid out, *so that he could check the return of the man who is alleged to have received such amounts.* . . .
>
> This case here : . . does present the question as to how much the taxpayer must keep and record his losses in such cases. . . ." [R. 14760 at 39-40.]

In short, the Commissioner issued the deficiency notice and tried the case to test the adequacy of the records maintained by petitioners even though his deficiency notice was based solely on the disputed record.

On the other hand, petitioners argued that the Commissioner cannot have his cake and eat it at the same time. That is, he cannot invoke Section 41 as authority, disregard the taxpayer's books and records as inadequate, and at the same time rely on that same inadequate record as the sole basis of his deficiency. If the Commissioner wishes to disregard books and records under Section 41, the following requirements must be met:

(1) The Commissioner must actually *disregard* the books and records.

(2) There must be a *method* of reconstructing income used. *Bradstreet Co. of Maine v. Commissioner,* 1 Cir., 1933, 65 F. 2d 943.

(3) The method adopted must be *reasonable. Schira v. Commissioner,* 6 Cir., 1957, 240 F. 2d 672; *Bradstreet Co. of Maine v. Commissioner, supra.*

(4) The method used must clearly *reflect* the taxpayer's income. *A. & A. Tool Supply Co. v. Commissioner,* 10 Cir., 1950, 182 F. 2d 300, 302.

At the trial below, petitioners placed into evidence the testimony of four witnesses, several exhibits, including Exhibit 3, the exhibit relied upon by the Commissioner, and offered certain net worth and disbursements evidence designed to show that petitioners could not have sustained the alleged additional income. [R. 14760 at 41-118.] After accepting into evidence the testimony of the witnesses and the exhibits, *including* Exhibit 3, the Tax Court, after objection by the Commissioner and a detailed explanation as to why it was being offered [R. 14760 at 76-85], rejected the net worth and disbursements evidence. [R. 14760 at 86.] This rejection occurred even though the Tax Court later held that petitioner's books and records were inadequate. In short, the Tax Court ruled in effect that net worth and disbursements evidence was not admissable in a case where it held that petitioner's books and records were inadequate. Yet at the same time it was holding that the taxpayers had not carried their burden of proof. In other words, to tell a taxpayer that he has

the burden of proof, and then refuse evidence which would allow him to carry that burden of proof is like telling a man that he is dying of malnutrition but cannot have food.

In its first ruling, the Tax Court, without saying how or why it arrived at the figure, decreased the additional income by $3,000. Clearly what it did was accept the entries appearing under the "Loss" column of Exhibit 3 to the extent of $3,000 more than the $345.22 accepted by the revenue agent. Why the entries under the "Loss" column were reliable to the extent of $3,000, the Tax Court has never said. Therefore, it must be obvious that the figure of $3,000 was picked out of thin air.

When the Tax Court's first decision was appealed to the Ninth Circuit, the latter, in a split decision, remanded it to the Tax Court "on the ground that the findings were not sufficiently definitive." U. S. Circuit Judge Pope, in a dissenting opinon, concluded that the Tax Court should be reversed.

Subsequently, wthout hearing further testimony or accepting further evidence, the Tax Court again sustained the Commissioner but decreased the alleged additional income by the same $3,000. However, instead of supplying further and more definitive findings of fact, it reduced its first findings of fact from 1496 words to 123 words. [R. 15710 at 22-27.] Included within these 123 words was a new finding of fact that

> "The petitioner did not keep regular, adequate and permanent books and records of his wagering transactions." [R. 15710 at 23.]

Therefore, petitioners again appealed to the Ninth Circuit which again remanded the case to the Tax Court in a second split opinion with Circuit Judge Pope again writing a dissenting opinion and urging reversal. In its second opinion, the Ninth Circuit majority ordered the Tax Court to receive further evidence saying:

> "Particularly the authenticity of Exhibit 3 should be a subject of injury." (*Showell, supra*, 254 F. 2d 461, 463.)

Commenting on the Commissioner's duty in that respect, the majority opinion stated:

> "We hope this is not a situation where the Commissioner and about four other agencies have taken the view that looking into the document is all someone else's business." (*Showell, supra*, 254 F. 2d 461, 462.)

U. S. Circuit Judge Pope warned that, if upon further evidence, the Tax Court should conclude that Exhibit 3 was a falsification, the Commissioner would still face his unperformed duties under Section 41, and would "leave the record more naked than ever of proof as to what the income actually was." (*Showell, supra*, 254 F. 2d 461, 464.)

Subsequently, the Tax Court held a hearing to receive further evidence respecting Exhibit 3. At that hearing the Commissioners qualified a handwriting expert who testified that the entries on Exhibit 3 were not made on the dates appearing opposite the entries. [R. 16872 at 79-81.] His testimony specifically included both the entries appearing under the "Gain"

column as well as under the "Loss" column. That is, the Commissioner placed a witness on the stand for the purpose of destroying the authenticity of the very exhibit [Ex. 3] which his agent testified was the *sole basis* of the Commissioner's determination of the deficiency here.

When the Tax Court issued its third opinion, a memorandum opinion, [R. 16872 at 84-90] it again decreased the asserted additional income by $3,000, readopted its previous 123 word findings of fact, and stated that:

> "Upon further consideration of the additional evidence introduced, we find no good reason to depart from the findings of fact and decisions previously entered. The evidence tends to support our previous distrust of the authenticity of Exhibit 3 as a contemporary record." [R. 16872 at 89.]

In short, the Commissioner and the Tax Court have rejected the sole basis of the former's determination of a deficiency.

Thereupon, the petitioners appealed to the Ninth Circuit for a third time. In its third opinion the Ninth Circuit held:

> ". . . no new evidence was offered by petitioners, and the court in effect rejected the Exhibit 3 as without probative value, there was no evidence upon which the Tax Court could redetermine anything. Under the Tax Court's Rule 32 . . . the burden of proof before the court was on the petitioner. Hence, upon final submission the court had nothing before it which it was willing to

> credit. The result is that the record last before the Tax Court simply *fails to furnish anything* to support the petition for redetermination. *Since the burden of proof was not met,* the decision must be affirmed." [R. 16872 at 106; 286 F. 2d 245, 246, Emphasis supplied.]

This then presents the issue to this Court. Does the burden of proof imposed upon taxpayers by Rule 32 of the Tax Court's rules mean that when the Commissioner disregards a taxpayer's books and records under Section 41, he may, nevertheless, use those same records as the sole basis of his deficiency and thereby make it impossible for a taxpayer to carry his burden of proof? If so, how can a taxpayer overcome a deficiency based upon his books and records when at the same time the Commissioner and the Tax Court have rejected those same books and records as inadequate? What happens in such a case is that the fact of rejecting the books and records concludes the matter so long as the Commissioner is careful *not* to adopt any method of reconstructing income as is required by Section 41. But surely this cannot be the rule because all rules of procedure must conform to the substantive rules of the Internal Revenue Code. Certainly Rule 32 of the Tax Court's rules cannot be interpreted so as to make the requirements of Section 41 meaningless. To rule that a taxpayer had not carried his burden of proof where the Commissioner's deficiency is based solely upon the records of the taxpayer but which records are subsequently attacked by the Commissioner and rejected by the Tax Court is equivalent to ruling that:

(1) Rule 32 of the Tax Court's rules is paramount to Section 41, Internal Revenue Code of 1939.

(2) Once the Commissioner rejects the taxpayer's books and records but, nevertheless, relies solely on them as the basis of the deficiency, he is in a better position than if he had complied with Section 41 and adopted a method of determining income.

(3) Where the Commissioner relies solely upon a part of a taxpayer's records, as the basis of his notice of deficiency, he will be sustained even though he succeeds in attacking the authenticity of the very records he relied upon.

Consequently, the real question here is whether Section 41 does require the Commissioner to adopt a method of reconstructing income where he rejects a taxpayer's books and records as inadequate.

Section 41, Internal Revenue Code of 1939, provides that:

"Sec. 41. The net income shall be computed upon the basis of the taxpayer's annual accounting period : . . in accordance with the method of accounting regularly employed in keeping the books of such taxpayers; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation *shall* be made in accordance with *such method* as in the opinion of the Commissioner does *clearly reflect* the income. . . ." (Emphasis supplied.)

Since the above language "if the method employed does not clearly reflect the income" has been interpreted by the courts, including the Tax Court, to comprehend the case where a taxpayer's records are inadequate, it follows that the Commissioner may, in such a case, redetermine income. But how?

At 2 CCH 1953 Fed. Tax Rep. ¶386.011 a portion of the answer is found:

> ".011. Reconstruction of income.—Where a taxpayer keeps no books or records *or his records are inadequate*, the Commissioner may under authority of Code Sec. 41 compute his income in accordance with *such method* as in the opinion of the Commissioner will *clearly reflect* the taxpayer's income." (Emphasis supplied.)

In giving further operational significance to Section 41, the courts have held that the *method* adopted by the Commissioner must be reasonable. (***Bradstreet Co. of Maine v. Commissioner***, 1 Cir., 1933, 65 F. 2d 943; *Schira v. Commissioner*, 6 Cir. 1957, 240 F. 2d 672; 2 Mertens, Law of Federal Income Taxation, §12.12.) And it has also been held that the *method* adopted must properly reflect the taxpayer's income. (*A. & A. Tool & Supply Co. v. Commissioner*, 10 Cir., 1950, 182 F. 2d 300, 302.) Furthermore, in the *Bradstreet* case, *supra*, the court said that: "the burden to adopt a *method* that will clearly reflect the income is on the Commissioner equally as well as on the taxpayer." And even the Tax Court itself said, in *H. T. Rainwater*, 1954 23 T. C. 450, that the destruction of records "*may* justify the Commissioner in using some reasonable method of reconstructing a taxpayer's income . . ."

Some of these methods which have been approved by the courts are (1) the net worth and disbursements method, (2) the bank deposit method, and (3) the percentage of gross receipts method.

From the foregoing paragraph, it can be seen that there are four requirements which must be complied with by the Commissioner when he disregards the taxpayer's records as inadequate. They are:

(1) He must *disregard* the records as inadequate.

(2) There must be a *method* of reconstructing income used.

(3) The method used must be *reasonable*.

(4) The method used must *clearly reflect* the taxpayer's income.

Applying these four tests to the instant case, what is the result?

First, there was no disregarding or rejecting of the taxpayer's records. Indeed, the Commissioner's examining agent testified that Exhibit 3 was the sole basis of the asserted deficiencies. That is, the very record which the Tax Court rejected as not being authentic and lacking veracity is the same record which the Commissioner used as the sole source of the alleged additional income of $22,503.66 ($22,908.88 less $345.22) one-half of which, or $11,281.83, was set forth in each of the two notices of deficiency. Certainly it cannot be argued on the one hand that the Commissioner is entitled to disregard the petitioner's record [Ex. 3] under the authority of Section 41 because such record is either inadequate or not authentic or not true and on the other hand contend that the same record [Ex. 3] provides the source or basis of the

alleged additional income of $22,563.66. Therefore, it is clear that the first requirement for invoking Section 41 has not been met.

Second, there must be a method of reconstructing income used by the Commissioner. Here there was no method used at all. The Commissioner simply extracted the total of the figures appearing under the "Gain" column of Exhibit 3 less 4 entries and adopted the sum as net income from wagering, while ignoring the companion figures appearing under the column entitled "Loss." Is this a *method* of determining income Is it a method that *clearly reflects* income? Petitioners submit that it is no method at all much less one which clearly reflects income. The word "method" according to the 1951 edition of the Thorndike-Barnhart Dictionary means "system in doing things; order in thinking." Two of the synonyms given are "plan" and "design." Yet where is the system or order when the Commissioner determines income by picking and choosing the entries in a taxpayer's records which reflect income, while at the same time ignoring each entry which reflects a lesser income? Surely it cannot be said that there were no methods available to the Commissioner to ascertain Jack Showell's net income if he was dissatisfied with the adequacy of his books and records. The net worth and disbursements method has been used in such cases along with the bank deposits and percentage basis. As the Tax Court itself stated in the similar and later case of *Ross v. Commissioner*, 15 T. C. M. 23; Dec. 21,511 (M); T. C. Memo 1956-5:

> "Respondent's statutory notice determines no fraud, mathematical inaccuracy, or *specific* dis-

crepancy with respect to the 'outs.' This position is, in substance, that there is no practical way in which he can verify by audit the amount of the 'outs' because petitioners did not require receipts for 'outs' or obtain the names and addresses of winning bettors. We doubt whether such data would have been of material assistance in an audit because it is unlikely that true names and addresses would have been furnished to bookmakers. We recognize the difficulty of an effective audit, however, we do not think the solution lies in the effort to apply an unrealistic formula. Other techniques, such as determination of income by the net worth increase method, have been developed which have been quite effective in ferreting out unreported income where the usual auditing methods are inadequate. No such method has been availed of in the instant case."

Likewise, in the instant case, the net worth and disbursements method, as well as any other method which would clearly reflect income, was available to the Commissioner when he had concluded that the taxpayer's records were inadequate. Yet no method was adopted here.

Furthermore, the Tax Court refused to sustain the Commissioner in two later cases nearly identical to the case at bar stating that such a reasonable *method* of determining income was lacking. (*Ross v. Commissioner*, *supra*, and *Snyder v. Commissioner*, 14 T. C. M. 1126, Dec. 21,310(M), T. C. Memo. 1955-293.) In each of these cases and in the *Rainwater* case, *supra*, the taxpayer was a bookmaker whose books and records were

held inadequate. In each case the Commissioner disregarded the net loss shown on the taxpayer's permanent record and limited them to a percentage of the gross intake currently being paid out by race tracks. In each case the Tax Court held that the reconstruction of the income was *arbitrary* on the ground that a bookmaker's loss percentage was not likely to correspond with that of a race track. Yet in the case at bar there was no formula of any kind used, no utilization of any method of determining income, and still the Tax Court sustained the Commissioner. Thus, the Commissioner has found an ideal solution to the problem which is not to adopt any method at all. Do not use percentages, do not use net worth and disbursements or bank deposits, but simply disregard certain entries in a permanent record. In this case the Tax Court is saying that although the books and records are inadequate in its opinion, the Commissioner may extract those figures appearing under the "Gain" column and reject everything else. If allowing losses equal to a percentage based on race track losses is arbitrary, how can a pure and unadulterated guess both by the Commissioner and the Tax Court be reasonable? When the Commissioner uses a method of determining income such as the net worth and disbursements method he cannot make an arbitrary guess as to any of the net worth components. (*Thomas v. Commissioner*, 1 Cir., 1956, 232 F. 2d 520.) How, then, can the Commissioner or the Tax Court be permitted to guess when no method of any kind is used?

Nor is the lack of the requisite "method" alleviated by the argument advanced by the Tax Court in its first opinion that the "Gain" figures were admissions

against interest. The requisite "method" of accounting called for by Section 41 cannot be created or brought into existence simply by invoking a legal rule of evidence, even assuming it is correct in its application. This is because the statute itself requires a "method" if the Commissioner decides the books are inadequate. Thus, once the Tax Court finds as fact, as it has in the second and third opinions, that petitioner's books and records were inadequate, the admissions against interest argument as applied to the "Gain" column becomes irrelevant. In short, the legal concept of admissions against interest, even if the Tax Court had correctly applied it, is not a method of determining income as required by Section 41.

If the Commissioner had adopted the net worth and disbursements method or any other method for that matter, petitioners could submit evidence in reply. However, in this case the Commissioner and the Tax Court used no method at all. Instead the Commissioner relied entirely on the legal presumption of *prima facie* correctness of his determination which evaporated at the trial when contrary evidence was placed in the record. (*J. M. Perry & Co. v. Commissioner*, 9 Cir. 1941, 120 F. 2d 123; 9 Mertens, Law of Federal Income Taxation, §50. 71 (1943).)

Under Section 41 of the 1939 Internal Revenue Code, the Commissioner may bypass or ignore a taxpayer's books and records which he deems lacking or inadequate, but he must then adopt a *method* of reconstructing income which is reasonable and clearly reflects income. Here the Commissioner cannot have it both ways. He cannot conclude that a taxpayer's records are inadequate, and still maintain that he is not required to adopt

any method of ascertaining income. To rule otherwise means that there is no way of overcoming a deficiency determined after the Commissioner rejects a taxpayer's books and records so long as the Commissioner fails to adopt any method of reconstructing income.

Thirdly, there is the requirement that the method used must be reasonable. This surely has not been the case here. Is a method, assuming a method has been used, reasonable when it is based upon a record [Ex. 3] which both the Commissioner and the Tax Court decided was not authentic, not true, and inadequate? Is it reasonable to say that a taxpayer's records are inadequate and not authentic and at the same time rest a deficiency in income tax upon that same record?

The fourth requirement is that the method used must clearly reflect the taxpayer's income. Assuming *arguendo* that what the Commissioner has done constitutes a *method* of determining income, does it clearly reflect income as required by Section 41? The comments of the Tax Court and Judge Chambers both reflect that neither this Court nor the Tax Court thought any method was used. Judge Chambers indicated that the determination may be "half arbitrary" or "half intelligent," (*Showell v. Commissioner*, 9 Cir., 1956, 238 F. 2d 148, 152), while the Tax Court called it "speculative" (*Showell v. Commissioner*, 16 T. C. M. 103, 105, Dec. 22,239(M), T. C. Memo. 1957-22). Why is this necessary when Section 41 provides methods of ascertaining income, approved by the courts, if the Commissioner refuses to accept a taxpayer's books and records? None of these methods, including the net worth and disbursements method, was even attempted by the Commissioner in this case. Petitioners submit that the

fair inference to be drawn is that none of these methods resulted in deficiencies. If the Commissioner rejects the adequacy of a taxpayer's records, as was done here, does it make sense that he may base a deficiency solely upon those same records, or must he, as Section 41 requires, adopt a method of determining income? Of course the Commissioner can adopt any procedure he desires so long as he relies upon the legal presumption of correctness which attaches to his deficiency. But the question is what is left after the presumption evaporates, as it did here?

Petitioners submit that the law of Federal income taxation, as developed by the courts through the interpretation given Section 41 of the 1939 Internal Revenue Code, makes it unnecessary for the Tax Court or a United States Court of Appeals to approve a determination by the Commissioner which is "half arbitrary, half intelligent" or "speculative." Nor is it any answer to cite *Cohan v. Commissioner*, 2 Cir., 1930, 39 F. 2d 540, as did the Tax Court in its second memorandum opinion. *(Shouell v. Commissioner*, 16 T. C. M. 103, Dec. 22,239(M), T. C. Memo. 1957-22.

Cohan v. Commissioner, supra, is not authority for the proposition that the Tax Court may sustain a determination which by its own words is "speculative." In that case George M. Cohan ***kept no record*** at all of the amounts he spent for entertainment. The Tax Court, therefore, refused to allow Mr. Cohan any part of the sums spent, as a deduction, on the ground that it was impossible to tell how much he had in fact spent. The United States Court of Appeals for the Second Circuit held that the Board was *inconsistent* when it said on the one hand that something was spent, but on

the other hand allowed nothing, and, therefore, it ordered the Board to reach some allowance. But is this the situation in the case at bar? In the *Cohan* case, *supra*, the taxpayer maintained no records. In the case before the Court, petitioner Showell maintained a daily permanent record which served as the sole basis of the Commissioner's deficiency determination. In the *Cohan* case, *supra*, the Court of Appeals held the Board was being inconsistent when it said something was spent, but allowed nothing. Is the Tax Court not inconsistent here when it finds as fact that petitioner's books and records of wagering transactions were irregular and inadequate while at the same time sustaining a deficiency based on the entries found in those same inadequate and irregular books and records?

Petitioners submit that the Tax Court and the Court of Appeals erred in sustaining a determination of income based upon no reasonable method which clearly reflected income but upon the very record [Ex. 3] which it rejected as not authentic or accurate. That is, it may not find that the record was inadequate and then sustain a determination of income, based not upon a method of ascertaining income, but upon that same record and a guess that $3,000 more should be allowed as an offset to the Commissioner's determination.

Conclusion.

For the foregoing reasons, petitioners submit that this petition for a Writ of Certiorari should be granted.

Respectfully submitted,

W. Lee McLane, Jr.,
Nola McLane,
Counsel for Petitioners.

APPENDIX A.

Opinion of the United States Court of Appeals for the Ninth Circuit.

United States Court of Appeals for the Ninth Circuit.

Jack Showell, *et al.*, Petitioners, vs. Commissioner of Internal Revenue, Respondent. No. 16,872.

Jan. 9, 1961.

On petition to review a decision of the Tax Court of the United States.

Before Chambers, Chief Judge, Pope and Merrill, Circuit Judges.

Per Curiam.

This is the third time this court has had occasion to review decisions of the Tax Court upon the Petitioners' petitions for redetermination of income tax deficiencies for the year 1949. See Showell v. Commissioner, 238 F. 2d 148, Showell v. Commissioner, 254 F. 2d 461. The Commissioner's determinations showed a deficiency of $3,946.65 for Jack Showell and of $4,065.69 for Dorothy Showell. The decision of the Tax Court, each time, fixed the deficiencies due from these two petitioners at $3,286.65 and $3,392.25.

Upon our first review we expressed dissatisfaction with the Tax Court's findings, particularly as respects a written Exhibit 3 which the Tax Court had apparently credited in part, and stated: "We have such dissatisfaction with [the findings] that we have determined to send the case back to the Tax Court to make new findings." We also held that petitioners' claim

that they should have been allowed to prove their income by "net worth" proof, was not supported by sufficient foundation or offers of proof. The case was remanded for further proceedings.

Upon the second review, which was of the Tax Court's decision following our first remand, we disposed of the case as follows: "We remand the case to be reopened by the Tax Court to receive further evidence. Particularly the authenticity of Exhibit 3 should be a subject of inquiry. It should set aside its findings and decision." Thereafter the petition for redetermination came on for hearing in the Tax Court pursuant to our remand. Counsel for petitioners was asked if he proposed any additional evidence. He replied in the negative. The respondent Commissioner then produced an expert witness who testified that the entries on Exhibit 3 were not made on the dates shown for the transactions there indicated, but that a portion of the numerous entries were all written at one time and the remaining portion all at another time;—in short, that Exhibit 3 was not a document kept in the normal course of bookkeeping business; that it was not a contemporaneous business record. Petitioners cross-examined this witness but produced no further evidence.

The Tax Court found that "The petitioner did not keep regular, adequate and permanent books and records of his wagering transactions." It determined the deficiencies to be the same as previously decided.

When we remanded the case "to receive further evidence" we did not limit or define the scope of such evidence. When no new evidence was offered by petitioners, and the court in effect rejected the Exhibit 3

as without probative value, there was no evidence upon which the Tax Court could redetermine anything. Under the Tax Court's Rule 32, adopted pursuant to §7453 of Title 26, the burden of proof before the court was on the petitioner. Hence, upon final submission the court had nothing before it which it was willing to credit. The result is that the record last before the Tax Court simply fails to furnish anything to support the petition for redetermination. Since the burden of proof was not met, the decision must be affirmed.

It Is So Ordered.

(Endorsed) Per Curiam Opinion Filed Jan. 9, 1951.
Frank H. Schmid, Clerk.

APPENDIX B.

Judgment.

United States Court of Appeals for the Ninth Circuit.

Jack Showell, *et al.*, Petitioners, vs. Commissioner of Internal Revenue, Respondent. No. 18,872.

Upon petition to Review a Decision of the Tax Court of the United States.

This cause came on to be heard on the Transcript of the Record from the Tax Court of the United States and was duly submitted.

On Consideration Whereof, It is now here ordered and adjudged by this Court, that the decision of the said Tax Court of the United States in this cause be, and hereby is affirmed.

(Endorsed) Filed and Entered January 9, 1961.

Frank H. Schmid, Clerk.